B. There Is Substantial Evidence That Vertical Integration of Cable Operators Is Procompetitive.

Standard economic theory and a substantial body of law hold that vertical integration is procompetitive. 23/ Vertical integration has played a historically important role in the development of cable programming. For many years, cable operators and their affiliated companies have taken substantial risks to foster the development of high-quality cable programming.

For example, in 1986, when Turner Broadcasting System (now providing such services as CNN, WTBS-superstation, TNT,

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23/ It has been widely recognized by numerous scholars that firms achieve many efficiencies through vertical integration. See, e.g., 3 Phillip E. Areeda & Donald F. Turner, Antitrust Law: An Analysis of Antitrust Principles and Their Application, 724-25 (1978) (arguing that prohibitions against vertical integration should be the exception rather than the rule because vertical integration can create two types of efficiency gains--production economies resulting from technological interdependencies and market transactions cost savings); F. M. Scherer, Industrial Market Structure and Economic Performance 87 (1970) (proposing that vertical integration creates savings in market transaction costs).

Similarly, the courts generally have not treated vertical integration as a threat to competition; rather, decisions looking at the behavior of vertically integrated firms often have acknowledged the pro-competitive effects of their integration. See United States v. Columbia Steel Co., 334 U.S. 495, 525 (1948) (vertical integration in itself does not violate Sherman Act); Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698, 710 (7th Cir.) ("[v]ertical integration is a universal feature of economic life and it would be absurd to make it a suspect category under the antitrust laws"), cert. denied, 469 U.S. 1018 (1984).

the Cartoon Network and Turner Classic Movies) encountered financial difficulty, a number of MSOs invested capital. Furthermore, the Chairman of the Discovery Channel, John S. Hendricks, has testified before Congress that investment by cable operators "rescue[d]" his programming service. 1990 Report ¶ 83, 5 FCC Rcd. at 5009 (quoting statement of John S. Hendricks before the Subcommittee on Communications of the Senate Committee on Commerce, Science and Transportation). Similarly, investments by cable operators have promoted the development of a variety of new and diverse programming services, including C-SPAN, BET, QVC, Court TV, Comedy Central and E!. Indeed, the pay cable industry can trace its origins to the efforts of Manhattan Cable TV (a TWC cable system) to develop HBO in the early 1970s in order to attract cable subscribers. 24/

Vertical integration has played an important role in developing cable programming because cable operators have powerful incentives to develop high-quality popular

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24/ The Commission's failure to credit the benefits of vertical integration in the 1994 Report contrasts sharply with its earlier recognition of those same benefits. In the 1990 Report, the Commission stated that "vertical integration produces significant benefits for cable subscribers". 1990 Report ¶ 82, 5 FCC Rcd. at 5008-09; see also United States Dep't of Commerce, Video Program Distribution and Cable Television: Current Policy Issues and Recommendations, NTIA Rpt. 88-233 at 90 (1988) ("Common ownership of a cable system and a cable program service may produce significant benefits for the integrated firm and its customers".).

programming. As the Commission has noted, vertical integration "can help a cable company avoid transaction costs normally incurred in acquiring programming". 1990 Report ¶ 84, 5 FCC Rcd. at 5009; see also 1988 NTIA Report at 90 ("[t]he principal benefit is that vertical integration allows the cable firm to avoid the transaction costs of obtaining programming"). The expenses saved in time, human resources, and negotiating and enforcing program contracts may be passed on as savings to the cable consumer. In turn, the support of the cable operator aids the start-up programmer by providing needed capital and ensuring a guaranteed subscriber base. See 1990 Report ¶ 84, 5 FCC Rcd. at 5009.

Just as cable operators have developed programming themselves and have affiliated with programmers, non-cable Multichannel Video Programming Distributors have begun to do the same. For example, DirecTV, an affiliate of General Motors Corporation, recently entered into direct agreements with the National Football League and the National Basketball Association to carry unprecedented numbers of NFL and NBA games on its 150-channel-plus service. 25/ Indeed,

25/ DirecTV's NFL deal has enabled it to offer subscribers all regular season games in an "NFL Sunday Ticket" package for approximately $150. "NFL, GM Agree to Digitally Broadcast Regular Season Games", Wall Street Journal, Oct. 7, 1994, at B-10. Under its agreement with NBA, DirecTV carries more than 400 games, which are sold for $149 as an "NBA League Pass" package. "GM Digital Service the NFL games package was not made available to cable operators, including TWC, even though TWC expressed interest in offering those games to its subscribers.

Similarly, a number of telephone companies have waged successful legal battles seeking permission to produce programming for distribution on their own video systems, and are in the process of marshalling vast resources to generate such programming. 26/ Thus, vertical integration is a logical and economically efficient result of market forces--not, as the Commission suggests, a vehicle for anticompetitive practices by cable operators.

C. Commission Rules Actually Discourage Innovation and Diversity in Programming.

In the 1994 Report and the 1995 NOI, the Commission asserts that the channel occupancy, program access and program carriage rules have been successful. 27/ That

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Starts Televising NBA Tomorrow", Wall Street Journal, Nov. 30, 1994, at B-12.

26/ The telephone companies' court victories on their challenges to the cross-ownership rules were followed closely by the Commission's own announcement that it would not enforce the rules in most circumstances. See 1995 NOI ¶¶ 48-49. The Commission is well aware of the various telephone company agreements and negotiations on programming ventures. Id. ¶ 55.

27/ See 1994 Report ¶¶ 173 (suggesting that lack of negative comments and small number of complaints indicate that program access and program carriage rules have been successful), 190 ("silence . . . is a strong indication that there are no significant violations of the [channel occupancy] rules and that the rules are not unduly assertion is not supported by any evidence. Indeed, the only evidence is that the rules have not been used extensively. There is no support for the Commission's attempt to attribute trends in programming to those rules.

At the same time, there is every reason to believe the Commission's rules discourage the development of programming. The rules generally constrain the ability of cable operators to produce programming by diminishing or removing economic incentives to do so. Cable operators are less likely to produce programming if they may not be able to deliver it on their own systems because of the channel occupancy rules, or if they are forced to make that programming available to their competitors. Similarly, cable operators are less likely to risk scarce channel capacity on an unproven network if they cannot offer that network on an exclusive basis program carriage rules. Thus, the Commission's denial of Time Warner's petition for a waiver with respect to its exclusive arrangement with Court TV was a powerful disincentive for Time Warner to invest in programming. 28/ Indeed, Time Warner has not invested in

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restricting the ability of vertically-integrated MSOs to deliver programming to their customers"), 9 FCC Rcd. at 7528, 7535.

28/ See Time Warner Cable--Petition for Public Interest Determination Relating to Exclusive Dist. of Courtroom Television, Memorandum Opinion & Order ("Court TV Exclusivity Order") ¶ 26, FCC 94-132 (No. CSR-4231-P June 1, 1994).

any new conventional cable programming services since the passage of the 1992 Cable Act because it lacks confidence in the ability of any new programming service to obtain carriage under the 1992 Act's regulatory scheme.

Moreover, the rules discourage diversity in programming. For example, the ability to negotiate an exclusive contract with a programmer reduces a cable operator's risk of investing in the programming, and creates an incentive to invest by enabling the operator to differentiate its system from those of competitors. Exclusive contracts are also attractive to cable operators because they protect the operator from free-riding by its competitors on promotional efforts. See, e.g., United Video, Inc. v. FCC, 890 F.2d 1173, 1178, 1179, 1182 (D.C. Cir. 1989) (notice Commission's conclusion that "exclusivity gives stations the opportunity to promote themselves as the only presenter of a certain program" while "duplication lessens the value of programming"). Yet the Commission's rules preclude such exclusive contracts, thereby discouraging diversity.

Aside from their deficiencies as regulatory policies, the Commission's rules suffer from serious constitutional infirmities. The Commission's content-based evaluations of programming contracts constitutes standardless discretion in violation of the First Amendment. See, e.g., FW/PBS v. City of Dallas, 493 U.S. 215, 225-26 (1990) ("unbridled discretion in the hands of a government official or agency constitutes a prior restraint and may result in censorship") (citation omitted). Similarly, where the Commission determines prices, terms and conditions for cable programming, the fundamental constitutional principle that the state may not prescribe what a speaker may charge for its speech is contravened. See Riley v. National Fed'n for the Blind of North Carolina, Inc., 487 U.S. 781, 789 (1988).

We also believe the Commission was flatly wrong to conclude--after having rejected previously that it had authority to do so--that it can award damages in a program-access dispute (even if the Commission has held, for the time being, that it will not do so). Program Access Order on Recon. When appropriate, Time Warner intends to pursue its challenge to the legality of those provisions and the Commission's regulations to the fullest extent possible.

III. THE COMMISSION SHOULD ALLOW THE MARKETPLACE TO DETERMINE THE DEVELOPMENT OF A RETAIL MARKET FOR SET-TOP BOXES.

The Commission invites comment on whether it should take steps to promote the development of a competitive retail market for consumer-owned set-top boxes. 29/ As

29/ See 1995 NOI ¶ 73.

explained below, there are compelling reasons why the Commission should not try to dictate the manner in which a retail market for set-top boxes develops. Rather, the Commission should permit market-driven solutions to this complex issue.

As noted above, cable operators are increasingly subject to competition from DBS, MMDS, SMATV, telcos and other Multichannel Video Programming Distributors. Each of these video programming distributors has the incentive to differentiate its products from the services provided by its competitors. One way in which some have already done so, or plan to do so, is through subscriber purchase of set-top boxes at retail stores. DirecTV, for example, requires that subscribers to its DBS services own their own set-top boxes. Bell Atlantic plans to permit subscribers on its Dover Township video dialtone system to do the same. 30/

Thus, the creation of a retail market for consumer equipment already has begun. If adequate demand exists, that competitive market will develop. It would be unwise, however, for the government to substitute its judgment for that of the marketplace and attempt to dictate the pace of

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30/ Bell Atlantic reportedly plans to separate the security functions of set-tops from their other functions. Subscribers will be able to buy boxes that perform the non-security functions.

this process. An analysis of the benefits and costs of subscriber ownership demonstrates why this is so.

The potential benefit of mandating or permitting subscriber ownership is that there may be a consumer preference for distribution systems on which box ownership is possible. 31/ This preference will obviously be more important for some consumers than for others. But when combined with other considerations, such as the price, quality and diversity of their video services, distributors like DirecTV and Bell Atlantic are hoping that the right to own boxes will cause consumers to choose their services.

The costs of subscriber ownership of set-tops are more numerous. First, the network operator runs the risk that subscriber ownership will endanger the security of the messages delivered over the system. This is already a severe problem. It has been estimated, for example, that signal theft costs the cable industry $4.7 billion in unrealized revenue annually. 32/ Permitting subscriber box

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31/ This preference could be the simple desire to own the box or the desire to own a different box (one that is less expensive and has fewer features or more expensive and better features) than the one available from the other distributors.

32/ See National Cable Television Association, "1992 Theft of Service Survey Results." The NCTA is currently researching an updated survey of cable service theft. That research indicates that signal theft is at least as costly now, and probably significantly more costly, than at the time of the 1992 survey.

ownership would require cable operators (and perhaps other distribution network operators as well) to disaggregate set-top box security functions from other functions. Signal piracy, however, is demonstrably easier in this situation than where an integrated box is used.

Second, there is the distinct possibility that the distributor will become the victim of "bad lock-in" or "excess inertia" as some economists call it. This would happen if enough subscribers purchase set-tops that are incompatible with subsequently developed technology. The distributor might then be prevented from upgrading its system to the new technology because of overwhelming subscriber resistance. 33/ If competitor-distributors exist on whose systems subscribers do not own boxes, those distributors would be able to upgrade and, in the long run, gain a potentially substantial competitive advantage over their "locked-in" competitor. Moreover, the inability of the locked-in system to evolve with technology reduces its value and denies users benefits that more sophisticated technology makes possible.

33/ See Michael L. Katz and Carl Shapiro, "Product Introduction with Network Externalities," The Journal of Industrial Economics, Vol. XL, at 55 (Mar. 1992) ("Network Externalities"); Michael L. Katz and Carl Shapiro, "Product Compatibility Choice in a Market with Technological Progress," 38 Oxford Economic Papers 146 (Nov. 1986).

Finally, and ironically, there is the possibility that subscriber set-top ownership will, in and of itself, lead to subscriber dissatisfaction. Thus, if some \subscribers (but not enough to force bad lock-in) purchase boxes that become obsolete, they will not be able to benefit from new services offered on a subsequently upgraded system. Likewise, subscribers might purchase set-tops on the open market that result in degradation of existing services which they mistakenly blame on the distributor. In both cases, the distributor as well as the consumer are likely injured. The distributor's relationship with its customers suffers and, because it is likely that fewer people will use the distribution network, it becomes less valuable to those who do. 34/

A uniform, national assessment of the likelihood of these problems is simply not possible. The significance of each problem will be different for differently situated distributors. Operators planning major upgrades of older systems, for example, may face a greater risk of bad lock-in than operators whose systems are new. Even similarly situated operators may resolve the issue differently. Thus, while DirecTV subscribers own their own boxes, subscribers to Primestar (an affiliate of TWC), another DBS provider, do not.

34/ See Network Externalities at 56.

Furthermore, regardless of the decisions reached, consumers will be able to participate in the pricing efficiencies of a highly competitive equipment market. 35/ Distributors subject to effective competition have every incentive to pass on low set-top box prices to consumers. Even when a cable system might not fully share those incentives, the cost-based regulation of set-top box prices required under the Communications Act prevents overpricing. 36/

Proponents of a governmentally created retail set-top market may contend that the problems just described are the same as those relied on by AT&T when it opposed the retail sale of customer premises telephone equipment. But this is wrong for two critical reasons. First, set-top boxes in video distribution systems perform much more important functions than customer premises equipment ("CPE") performs in a telephone system. A cable set-top box handles the security, integrity and signalling functions that are handled by the switch in a telephone central office, not by the subscriber's telephone. Thus, because the set-top box

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35/ The market for video consumer equipment is crowded with competitors. General Instrument Corp., Scientific-Atlanta, Hewlett-Packard, Thomson, Panasonic, Pioneer, Sony and Zenith, among others, vie for market share. Moreover, other powerful potential competitors--AT&T Network Systems, IBM and Apple--are considering entering the market.

36/ See 47 U.S.C. § 543(b)(3).

performs switch-like functions, problems with CPE are much more serious for cable systems than for telephone systems. Moreover, the relative importance of the video boxes will only increase as cable systems are upgraded to include two way capabilities.

Second, where cable networks provide switched video services, any degradation in service that results from problems with set-top boxes will effect cable users more widely than is true when telephone CPE malfunctions. This is because the distributed bus architecture of cable systems likely will not be able to isolate the effect of a single malfunctioning box; the effect will be felt by many subscribers. In contrast, when CPE fails on a telephone system, all of which use a point-to-point architecture, only service on the CPE user's line is damaged.

Finally, addressing these issues by imposing government established standards would only create more problems than it would solve. Governmentally set cable standards would have a seriously chilling effect on the distributors' incentive to innovate. Thus, in the long run, the government would impose a form of bad lock-in. Moreover, standardizing the cable industry would be complex and expensive since it would require imposing a uniform protocol on all of the approximately 11,000 cable systems around the country, many of which utilize different standards.

In light of these facts, it is clear that it would be imprudent for the Commission to require the creation of a retail set-top market. On the one hand, the competitive process of testing consumer demand for a separate retail market has already begun on its own. On the other hand, government regulations designed to force acceleration of this process would be extremely risky. Such regulations could well result in security and bad lock-in problems as well as the other difficulties described above that would impose substantial costs on both video distributors and their consumers. The marketplace is far more able to assess the likelihood of these problems than is the government.

Conclusion

TWC urges the Commission to adopt an approach for its report to Congress that provides a more accurate assessment of competition related to the delivery of video programming than the 1994 Report. The state of competition, significant now, promises to become even more vigorous in the near future.

June 30, 1995

Respectfully submitted,

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CERTIFICATE OF SERVICE

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